

APPENDIX

REPORT ON OPEN
MARKET OPERATIONS

Reporting on open market operations, Mr. Sternlight made the following statement.

Desk operations since the November 20 meeting have been geared to providing reserves to support growth rates of 5 percent for M_1 and 8 1/2 percent for M_2 from October through December, with similar rates to continue into the early January period. In fact, monetary growth ran somewhat under these rates preferred by the Committee. As of this point, it is estimated that M_1 growth was at a rate slightly over 3 percent and M_2 at about 6 percent for November-December. Against this background, discount window borrowing tended to decline as the Desk sought to meet--or even more than meet--nonborrowed reserve path levels.

This might have been expected to produce an easing tendency in the money market, but as it worked out the money market was somewhat firmer in the latter part of the interval than in the early portion, at least partly because of exceptionally large demands for excess reserves around the year-end holiday weeks. Although path levels were revised to incorporate higher levels of demand for excess reserves as these became known, our knowledge tended to lag behind the actual development of that demand.

In the first portion of the period, the four-week block ended December 19, total reserves turned out, on average,

about \$40 million above path and nonborrowed reserves about \$80 million above path, if one counts as nonborrowed reserves a particular late-in-the-day borrowing caused by a computer problem. Borrowing averaged very close to the \$1.7 billion figure anticipated as appropriate for purposes of constructing the nonborrowed reserve path when the period was beginning. By the latter part of that four-week subperiod, however, the Desk was actually aiming for levels of nonborrowed reserves consistent with borrowing of around \$1.5 billion, essentially as a result of the slower growth in monetary aggregates and hence of demand for reserves. During that first four-week block, changes in reserve multipliers were minor and insufficient to warrant any change in the average four-week path. The funds rate averaged about 13 1/2 percent during those four weeks--right in the middle of the Committee's broad 11 1/2 - 15 1/2 percent range.

In the subsequent three weeks, which ends tomorrow, our path-finding efforts were complicated by greater changes in reserve multipliers and hard-to-predict surges in demand for excess reserves that were probably due in part to effects of the Christmas and New Year's holidays and statement date pressures. Paths for total and nonborrowed reserves were adjusted as the period progressed to allow for significant changes in reserve/deposit multipliers and, as mentioned earlier, for the unusual bulges in excess reserves. With demand for total reserves expected to fall considerably short

of path because of the weak growth in deposits, a further modest upward adjustment of \$150 million was made in the path for nonborrowed reserves to provide some supply-side encouragement to deposit growth, in order to encourage total reserves to approach path more closely. As this latest three-week subperiod has unfolded, the Desk aimed for levels of nonborrowed reserves consistent with borrowings in the area of \$1.1 to \$1.3 billion. At times, however, it has been difficult to gauge just how much borrowing would emerge under given conditions of reserve availability and this has been a complication in day-to-day operations. The current week, especially, has presented some surprises as borrowing has averaged only a little over \$600 million even though Federal funds have been around 14 percent.

As estimated at this point, total reserves in the three-week block ending tomorrow may be about \$200 million below path, with nonborrowed reserves probably a little above their upward-revised path. Up to today, borrowing in this three-week period has averaged about \$1,150 million, while the Federal funds rate averaged about 13.80 percent.

On balance, the System was a substantial net provider of reserves since the November meeting, as seasonal forces--especially currency in circulation--absorbed reserves in size. The Committee provided a temporary enlargement to the leeway for net change in outright holdings of Treasury issues between meetings, and the Desk used a portion of this added leeway in

meeting some of the needs around the year-end period. The System bought \$620 million of Treasury coupon issues in the market, nearly \$1.7 billion of bills in the market, and a net of about \$750 million of bills from foreign accounts, after allowing for sales of about \$200 million today. Repurchase agreements and matched sale-purchase transactions were used flexibly from day-to-day to adjust reserve availability in line with desired path values.

In the next few weeks there is likely to be some reversal of seasonal forces that absorbed reserves late last year, and this may well provide some opportunity for outright sales of securities, while still meeting the Committee's reserve growth objectives.

Financial markets regained considerable composure during the recent period as participants accumulated more experience in coping with the System's new approach to operations. There is still likely to be greater volatility than before the change, however, as participants are still somewhat uncertain about particular Desk moves, while other external events such as the Middle East situation have scarcely been a calming influence. On balance, interest rates worked their way irregularly lower in most sectors over the period, influenced particularly by indications of a slowing economy, moderation in growth of aggregates, and the view early in the period that the System was at least

tolerating and perhaps encouraging less stringent money market conditions. The moves were by no means one-way, though, as the market was also affected at times by reports that the economic situation was not really all that weak, that inflation remained very strong, and that the dollar remained limp. Disturbing international political news and the renewal of gold fever in more virulent form added further depressing influences.

Over the period, Treasury coupon issues were down in yield by about 25 to 70 basis points for intermediate issues, and by about 10-12 basis points for long-term bonds. Yields on tax-exempts were down more modestly, while corporate bonds were little changed, despite a moderate supply of new issues. Dealer positions in over-1-year issues fluctuated around a net even position as dealers prepared for new issues by going short, then took on supply at auctions and worked it down subsequently. Current positioning strategy seems to reflect a "stay close to shore" approach in light of all the uncertainties about the economy and the world political situation.

In the bill area, 3-month rates were little changed on balance, while the 6-month issues were down about 1/4 percent and longer bills down around 1/2 percent in yield. The different performance may have reflected Treasury financing and Desk activity to some extent, as the Treasury added to supplies of short bills while Desk purchases, especially for

customer accounts, tended to favor longer bills. In yesterday's 3-month auction the average yield was 11.94 percent, virtually the same as just before the last meeting. The 6-month issues went at 11.86 percent yesterday compared with about 12.04 before the November meeting.

Other short-term rates generally declined over the period. Commercial paper was down about 25-70 basis points, while CD's were down similarly. Most banks cut their prime rate from 15 3/4 to 15 1/4 percent, and a few went to 15 percent.

The Treasury was a substantial borrower during the past seven weeks, raising nearly \$5 billion through sales of coupon issues, and some \$8 1/2 billion through bills. Later this month the Treasury will announce plans to refund about \$7 billion of February 15 maturities, and probably raise some new funds as well. The public holds about \$4.6 billion of the maturing issues. The System holds about \$1 3/4 billion of the maturing issues and we would expect as usual to exchange these for new issues.

Summarizing net outright operations for all of 1979, System holdings were up by \$7.1 billion--comprised of increases of \$3.1 billion in bills, \$3.7 billion in Treasury coupon issues and \$0.3 billion in Federal agency issues.

Notes for FOMC Meeting

January 8, 1980

Scott E. Pardee

Mr. Chairman, since the last meeting of the FOMC, the dollar has declined across-the-board against major currencies. It has fallen by 3 percent against the German mark, 4 percent against the Swiss franc and pound sterling, and 5 percent against the yen. Under the circumstances, we can only be relieved that the result has not been worse.

There has been very little positive news for the dollar. The U.S. trade balance remains in substantial deficit; and given the latest round of oil price hikes by OPEC members and other oil-producing nations, hopes for significant improvement over the near term have diminished. The U.S. inflation rate remains excessively high, and again partly because of the oil price increases, few in the market expect an improvement over the next months. The dollar's decline over recent months will also work to put upward pressure on prices within the United States. By contrast, Germany and Switzerland have rates of inflation, which while high by their standards, are still half ours. Market participants are confident that they, and others, will do what is necessary to bring down their inflation rates.

As I indicated last time, the only positive element for the U.S. right now is the Federal Reserve's October 6 package. In the absence of those measures and the resulting higher interest rates in this country, I am sure that the dollar's decline over the past three months would have been much greater and the atmosphere much grimmer. Even so, widespread doubts remain in the exchange market about the Federal Reserve's resolve. As Governor Wallich noted yesterday, despite repeated lectures from Federal Reserve officials that the degree of restraint should be measured mainly by the growth of the monetary aggregates rather than interest rates, many market participants are unwilling to accept what we say at face value. Whenever interest rates have eased back here over the past weeks concern immediately emerges in the exchanges. The fear is that U.S. interest rates will be allowed to fall once again below current or expected rates of inflation for the United States or that the interest differentials will narrow once again between the United States and, particularly, Germany.

The major forces behind the decline of the dollar are of course more political than economic. Iran continues to hold the hostages. The U.S. freeze of Iranian assets remains on.

The Bank Markazi has embarked on a steady program of diversification out of dollars through foreign commercial banks and even going so far as to ask the central banks of Libya and Algeria to act as agents in washing the Bank Markazi's name. Diversification by other OPEC holders has also been somewhat greater than usual, but more out of [unintelligible] than out of malice toward the dollar. The Soviet invasion of Afghanistan was initially interpreted as a sign of U.S. weakness and weighed on the dollar. Concern over the international political situation has of course played a major part in the latest upsurge in the gold price, which rose from some \$389 an ounce at the time of the last FOMC meeting to as high as \$680 an ounce in Hong Kong earlier this week. In that market as well, Middle East official and private interests have been a major factor. Inflationary expectations are clearly still an element in the market for gold as well as in many other commodity markets.

Under the circumstances, we have had to adopt a defensive intervention approach. We have wanted to avoid taking on the Iranians or other diversifiers head on, since a sustained effort to hold a particular level could be very costly in terms of our ammunition. At the same time, we have wanted to avoid the impression that we are backing away or reverting to benign neglect. Thus, we have been out of the market on most days, but when we are in we have been forceful. Since much of the pressure has come out of the Middle East, some of our largest, and perhaps most effective operations, have been overnight in Hong Kong and Singapore. Our operations have been closely coordinated with the Bundesbank, which has been very helpful in its own intervention.

Overall, during the period the Desk sold \$1.1 billion of German marks in the market, of which some \$590 million was for System account. At the same time, the Bundesbank passed to us enough marks from its capital export conversion program so that we were able to repay more than we drew on the swap line, reducing debt from \$3.3 billion to \$3.1 billion. We also have sold \$22.7 million equivalent of Swiss francs, drawn under the swap with the BNS.

James L. Kichline
January 9, 1980

FOMC BRIEFING

Economic activity now appears to have expanded somewhat in the fourth quarter of last year while inflation continued at a rapid pace. At the time of the November FOMC meeting the staff had anticipated a decline in activity for the quarter, but consumer spending once again apparently was a good deal stronger than we had anticipated and there likely was a bit higher level of exports and government purchases as well. Nevertheless, evidence of economic weakness emerged during the quarter and the staff believes that activity currently is declining.

At the present time relatively little firm evidence exists on economic developments in December. For the consumer sector last month, reports by the major chains and other information give a mixed picture, suggesting that retail sales probably were not strong in real terms. Auto sales perked up from the very low rate in November, with sales of domestic models spurred by a return of rebates and dealer incentives. However, the domestic auto market generally remains weak, and producers have been making sizable cuts in their production schedules. For last quarter as a whole real consumer expenditures are estimated to have risen about 3 percent at an annual rate. Income to support those expenditures was generated by appreciable gains in employment in October and November--notably in trade and service industries. But consumers also had to rely on a reduced personal savings rate in order to maintain spending patterns, and the savings rate is estimated to have fallen below 4 percent for the first time since the Korean War.

Important forces at work in the economy are running against sustained growth of real personal consumption expenditures. Income generating

forces outside the consumer sector are weakening and the consumer sector in the aggregate appears to have little financial flexibility left, given the already low savings rate and high debt burdens. Moreover, there are in prospect continuing drains of income to the federal sector through both increases in social security contributions and the effect of a progressive tax system applied to inflating incomes. And, there will be a sizable amount of income drained off by OPEC and domestic oil companies. Predicting consumer behavior is, of course, a hazardous affair but the reasons arguing for a downturn in consumer spending have become increasingly compelling. The staff forecast embodies a drop in real consumer purchases this quarter and on into 1981.

Developments in the investment sector generally have been about as expected. Residential construction expenditures continued to decline last quarter in real terms, as they had in all of 1979. In November housing starts declined 1/4 million units at an annual rate to 1-1/2 million units, and we expect that they declined further in December. There is at present no shortage of reports indicating likely further declines in housing sector activity, and our forecast indicates declines into the spring. Over the remainder of the forecast horizon housing is projected to be a source of strength with the upturn assisted by an expected easing of mortgage market conditions and strong underlying demands.

In the business fixed investment sector, expenditures in real terms are estimated to have declined at about a 6 percent annual rate last quarter. To some extent the drop reflected strike activity as well as unusually weak purchases of autos and trucks which were bolstered in the quarter earlier by dealer discounts. Nevertheless, new orders and contracts generally have been flat in nominal terms since the spring and declining final sales and rising unutilized capacity is likely to induce some trimming of expenditure

plans. The staff is forecasting a moderate decline of business investment spending into mid-1981.

A number of changes have been incorporated in the federal sector outlook in the current forecast. A windfall profits tax has been included which adds on net about \$5 billion to revenues in calendar year 1980 and about \$10 billion in 1981. In addition we have assumed the scheduled social security tax changes in January 1981 will be implemented, and these will add about \$18 billion to receipts in that year. No discretionary fiscal stimulus is assumed, consistent with the administration's present plans in its forthcoming budget proposal. Overall there is considerable fiscal restraint built into the staff forecast, a key force moderating the projected size of the economic recovery in 1981.

The projected decline in real GNP this year--2-1/4 percent--and sluggish growth of only 1-1/4 percent in 1981 is consistent with growing slack in labor and product markets throughout the forecast period. The unemployment rate is projected to be around 8 percent late this year and drift higher in 1981. Manufacturing capacity utilization last quarter is estimated to have been a little over 84 percent, down about 2-1/2 percentage points from early in 1979, and utilization rates are expected to drift below 80 percent by 1981.

The growing slack in markets is expected to have some damping influence on inflation. But achieving considerable improvement in price performance is likely to be a slow process. The staff forecasts continuing large compensation increases and poor productivity, which together result in little reduction in unit labor costs. In 1981 projected compensation is held up by the huge scheduled increase in social security taxes which will likely feed through to prices rather quickly. Inflation rates also are affected adversely by energy price developments over the entire forecast

period. We have assumed a rise in imported oil prices of 32 percent this year and domestic oil prices--given world oil price assumptions and continuing decontrol of domestic crude prices--are expected to rise by about 60 percent. In light of these developments, and our economic forecast, it seems unlikely that the gross business product fixed weight deflator will be below 8 percent in the forecast period.

The short-run alternatives presented for Committee consideration focus on growth of the monetary aggregates over the three-month period from December to March. In this period the demand for narrowly defined money is expected to be relatively weak, reflecting the staff's projection of a first-quarter rise in nominal GNP of less than 5 percent at an annual rate. Thus, the odds are high that the Federal funds rate and other interest rates would decline over the next few months unless the Committee targets a relatively low M-1 growth. The 6 percent target suggested under alternative A seems likely to entail a rather substantial near-term drop of interest rates, and the 5 percent target of alternative B less of a drop, while the 4 percent target of alternative C might lead to little, if any, drop.

All three alternatives are likely to be associated with continuing relatively moderate growth in the broader aggregates -- that is, with growth well within the Committee's longer-run ranges. The lowest Federal funds rate anticipated at this time would be around 10 percent, under alternative A, and that rate is not likely to entail any substantial reintermediation of funds through banks and thrift institutions. Moreover, the aggregate financial asset accumulation is in any event likely to be constrained by deceleration of growth in disposable personal income and a personal saving rate remaining on the low side.

The projected short-run interest rate behavior of the various alternatives does, however, have implications for the pattern of interest rates over the remainder of the year and, as a practical matter, for the probability of attaining any particular long-run money target. For example, relatively high money growth and relatively low interest rates early this year -- when economic activity and demand for money is projected to be weakest

in any event -- would imply a need for relatively high interest rates later in the year, perhaps sharply higher depending on the longer-run target chosen by the Committee, if the supply of money in the latter part of the year is to be kept low enough to keep growth within the early target.

For example, if the Committee shows a rate of M-1 growth for the year as low as $4\frac{1}{2}$ percent, selection of a 6 percent M-1 growth over the next three months would mean that a considerable deceleration of M-1 would be required in the second half of the year. But at that time nominal GNP growth might have accelerated to the 8 to $9\frac{1}{2}$ percent area, or possibly higher. Money demand would have strengthened considerably further, requiring a Federal funds rate returning perhaps to the 15 percent area to suppress M-1 growth in the second half in face of such strong demands. However, so high a level of rates at that time would have the disadvantage of greatly imperiling the beginnings of recovery in economic activity now projected for early 1981.

Such considerations, not to mention problems that might be generated for the dollar on exchange markets, complicate the problems of setting a short-run money supply target at a time when the Committee may also be wishing to cushion declines that may be occurring in economic activity. Offsetting such declines might argue for accelerating money growth from its recent pace, but an acceleration to the 6 percent pace of alternative A would probably weaken the dollar on exchange markets and, as noted above, make it difficult in practice to attain a longer-run M-1 target that was significantly lower for the year without imperiling economic recovery. On the other hand, the 4 percent M-1 growth of alternative C could accentuate developing economic weakness if it were in practice associated with no or little interest rate decline and, therefore, kept market rates above a declining

expected return on investment. However, the low growth has the advantage of providing a bit more scope for financing the stronger expansion of nominal GNP expected later in the year, and for more assuring the level of rates late in the year needed to promote recovery in 1981. Moreover, a relatively modest growth would not appear to be particularly inconsistent with the reduced longer-run growth target that appeared to evolve out of the Committee's preliminary discussion yesterday.

Alternative B can be viewed as something like a compromise between these not really very wide extremes, though, as compared with alternative C, it might more probably be consistent with some early decline of interest rates to help cushion the prospective weakness of economic activity.

I should add that some combination of alternatives B and C is also a possible policy course over the next few months. The Committee might consider targeting a growth rate of, say, 5 percent for M-1 in the first quarter, but indicate its willingness to accept a growth rate of as low as, say, 4 percent if that growth rate turned out to be consistent with some decline in market rates, as it might if there is some downward shift in money demand extending into the early part of this year.